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COUNTER-CYCLICAL ECONOMIC POLICY



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The effects of the recent economic crisis have stretched policy frameworks in many OECD countries close to breaking point. Recent work by the OECD has examined how policies have interacted with the economic cycle over time and during the recent crisis. The main policy lessons are as follows:

- Policy-makers should take into account uncertainties about the functioning of the economy, the nature of economic shocks or the effects of policy and take their decisions accordingly.
- Policy in various areas will have to build in greater safety margins and to be more prudent during upswings.
- Appropriate fiscal rules can help prepare fiscal policy for the next downturn by leading to swifter consolidation during the upturn.
- The monetary and financial policy framework needs to achieve a better articulation between economic and financial stability.
- Financial policy needs to strengthen micro-prudential regulation, regulatory interventions may need to target emerging credit-driven bubbles and macro-prudential policies should address systemic risks.
- There may be a case for monetary policy leaning against the wind, if asset prices are driven by a credit boom and financial regulation is judged to be insufficiently robust.
- Changes to structural policy settings can improve the resilience of the economy to shocks and affect the degree of leverage households and firms take on.

Cycles were changing

1. Since the mid-1980s, business cycles have tended to become smaller in amplitude and longer during the expansionary phase with fewer recessions. This reduction in macroeconomic volatility was accompanied by greater asset price volatility, while economic and asset price cycles became more synchronised both within and across countries. The flip-side of the great moderation was greater risk-taking, which in combination with financial market innovations fuelled a considerable rise in private-sector debt, which proved to be a source of fragility in many countries. Furthermore, banking systems had become more pro-cyclical and banks became increasingly leveraged with their financing structure shifting away from deposits in many countries. As the pro-cyclicality of the banking sector amplifies cycles in the real economy, financial market instability can lead to severe downturns as demonstrated again by the recent economic and financial crisis.

Uncertainty complicates policy decisions

2. Deciding the appropriate policy in the face of an economic disturbance is complicated by pervasive uncertainties. Uncertainties may concern the structure of the economy and the nature of the shocks hitting the economy as well as how policy choices affect the economy.

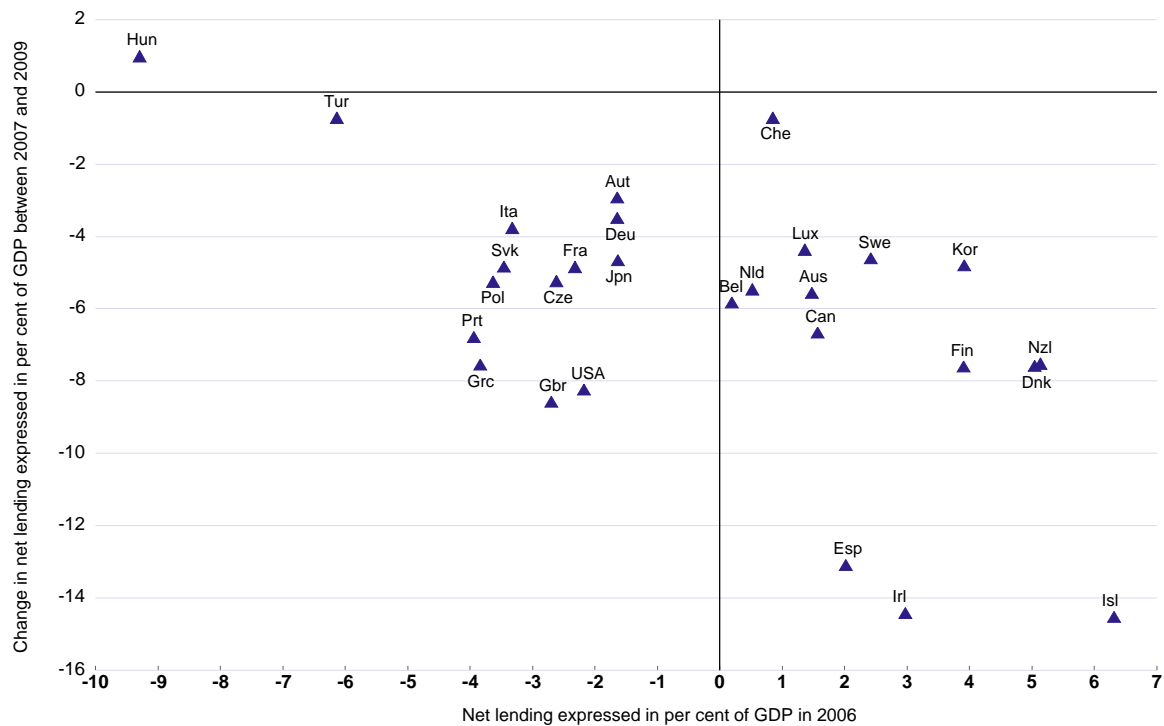
- Shocks originating in financial and housing markets can be particularly costly and macroeconomic policy addressing the shock needs to be aggressive. However, empirical attempts to identify emerging asset price misalignments are prone to sounding false alarms; and the ratio of false alarms to correct predictions can be high, implying costs if policy reacted systematically to such alarms. Risk assessment tools, such as early warning systems, therefore need to be developed further.
- Government deficits are not only affected by economic activity, but also by house and stock price cycles. Policy that did not take into account asset price changes painted too rosy a picture during the upswing prior to the economic and financial crisis. Improved measures of the cyclically-adjusted balance as well as accounting for the impact of asset prices on revenues would improve fiscal policy by helping to ensure that revenue windfalls are not used for permanent tax cuts or spending increases.
- Financial market developments and greater international linkages have made the effects of monetary policy more capricious, making it harder to determine the strength and speed of the required monetary policy impulses. For example, asset price developments and low long-term interest rates helped keep financial conditions loose for some time, despite tighter monetary policy before the economic crisis.

Precaution and safety margins for macroeconomic policies

3. An important lesson from the severity of the recent recession is that policy in various areas will have to be more prudent during upswings and to build in greater safety margins to be able to react to large adverse shocks.

- Some countries, where fiscal policy was already in a bad shape, were forced into a pro-cyclical tightening during the crisis, while countries with a comfortable budget surplus could implement more fiscal stimulus (Figure 1). Fiscal policy in countries running large deficits is typically less responsive in a downturn than in countries running small deficits or surpluses (Égert, 2010) and the effectiveness of policy also appears to be stronger when debt is low (Röhn, 2010). These experiences suggest wider fiscal safety margins are needed, particularly in the euro area where monetary policy may not be aligned with stabilisation needs. Some fiscal rules, such as combinations of limits on deficits and caps on spending growth, can help build up such margins and allow for more active fiscal policy during a downturn. But inappropriate fiscal rules, such as simple balanced budget rules, can be destabilising and fiscal rules sometimes lead to behaviour aimed at respecting the letter but not their spirit.

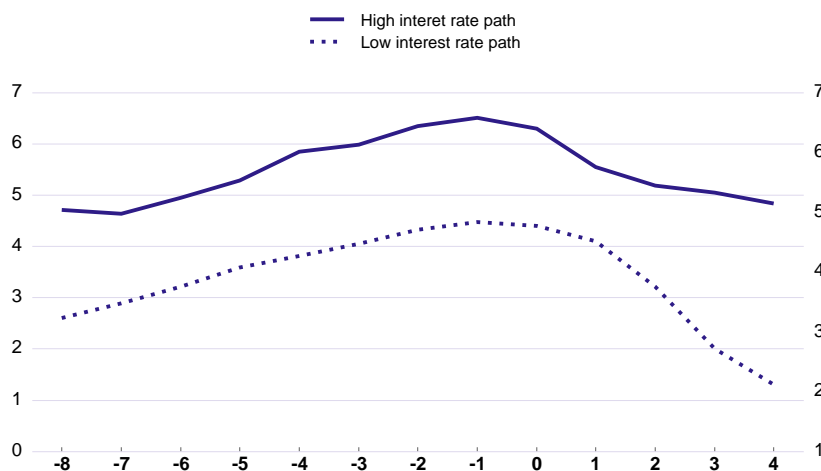
Figure 1. Fiscal positions on the eve of the downturn and subsequent loosening



Source: OECD Economic Outlook 87 database.

- Countries where inflation was relatively high found it harder to cut rates to support output stabilisation. Where monetary policy had effectively anchored inflation expectations, macroeconomic stabilisation appears to have been more potent, with central banks generally able to react more forcefully during the recent crisis (Figure 2). However, with interest rates hitting zero during the crisis in many countries, the scope for monetary policy to react became constrained. Monetary policy did not become completely ineffective but had to rely on non-conventional tools, the effects of which are less certain. While in principle recent events might call for raising the inflation target, for which a number of arguments can be made both for and against, the need to avoid destabilising inflation expectations at a moment of record government borrowing suggests not tampering for the time being.
- The difficulties facing stabilisation policy are more severe in small, open economies. Monetary policy that affects the exchange rate may be a potent stabilisation instrument, but at the price of leading to resource shifts between the open and sheltered sectors. Exchange rate interventions can potentially offset some of these impacts, though such actions would need to rest on an assessment of misalignments, which are difficult to identify. As a result, when monetary policy changes induce unwanted exchange rate movements, stabilisation policy requires relatively more support from fiscal policy. However, the effectiveness of fiscal policy is also limited, not least because stimulus leaks abroad through higher imports. In this light, fiscal safety margins need to be significantly larger to assist stabilisation in a small, open economy.

Figure 2. Short-term interest rates around the last turning point



Note: The evolution of short-term interest rates just prior to and after the economy entered recession are displayed in the figure. The high and low interest rate paths shown in the figure are the upper and lower quintile of the observations for all OECD countries. During this downturn policy rates fell more quickly than the short-term interest rates displayed in the figure.

Source: OECD Economic Outlook 87 database.

Policies to address financial turmoil

4. In the financial sector, capital buffers of banks were too small to withstand the losses stemming from the crisis in many countries. Financial sector policy settings need to be reconfigured to damp unnecessary volatility and ensure robust micro-prudential regulation. Prior to the recent crisis, greater risk-taking, in combination with financial market innovations, fuelled a considerable rise in private-sector debt, which proved to be a source of fragility in many countries, but not all (Figure 3). Indeed, the differing experiences of countries in the recent crisis suggest that robust micro-prudential regulation can help shield the financial sector from the worst effects, which has been the case in Canada, a country with low interest rates in the build-up to the crisis. Recent international initiatives suggest ways to reduce the pro-cyclicality of the financial system by raising its shock absorption capacity and dealing with incentive problems. The pro-cyclicality of the financial system can be reduced by:

- Aiming at higher, counter-cyclical and possibly contingent capital buffers to strengthen the banking sector's shock-absorption capacity.
- Implementing a system of provisioning for bad loans that provides sufficient buffers during a downturn.
- Better aligning incentives and remuneration packages with long-term shareholder interests.
- Addressing moral hazard problems for systemically important financial institutions that are deemed too important to fail through resolution mechanisms or adequate separation of their activities.

5. Without strong guidance about the likely direction of asset price movements, monetary policy should adopt a precautionary approach of guarding against an unnecessarily lax stance that may stoke misalignments as well as being prepared to deal with the aftermath of a bubble bursting. That said, detecting large asset price misalignments is feasible and this is particularly the case when exuberant credit

growth is fuelling excessive asset price increases, a constellation that also tends to incur higher economic costs when the bubble bursts. A combination of policies would either mitigate some of the costs or help address directly emerging asset price booms:

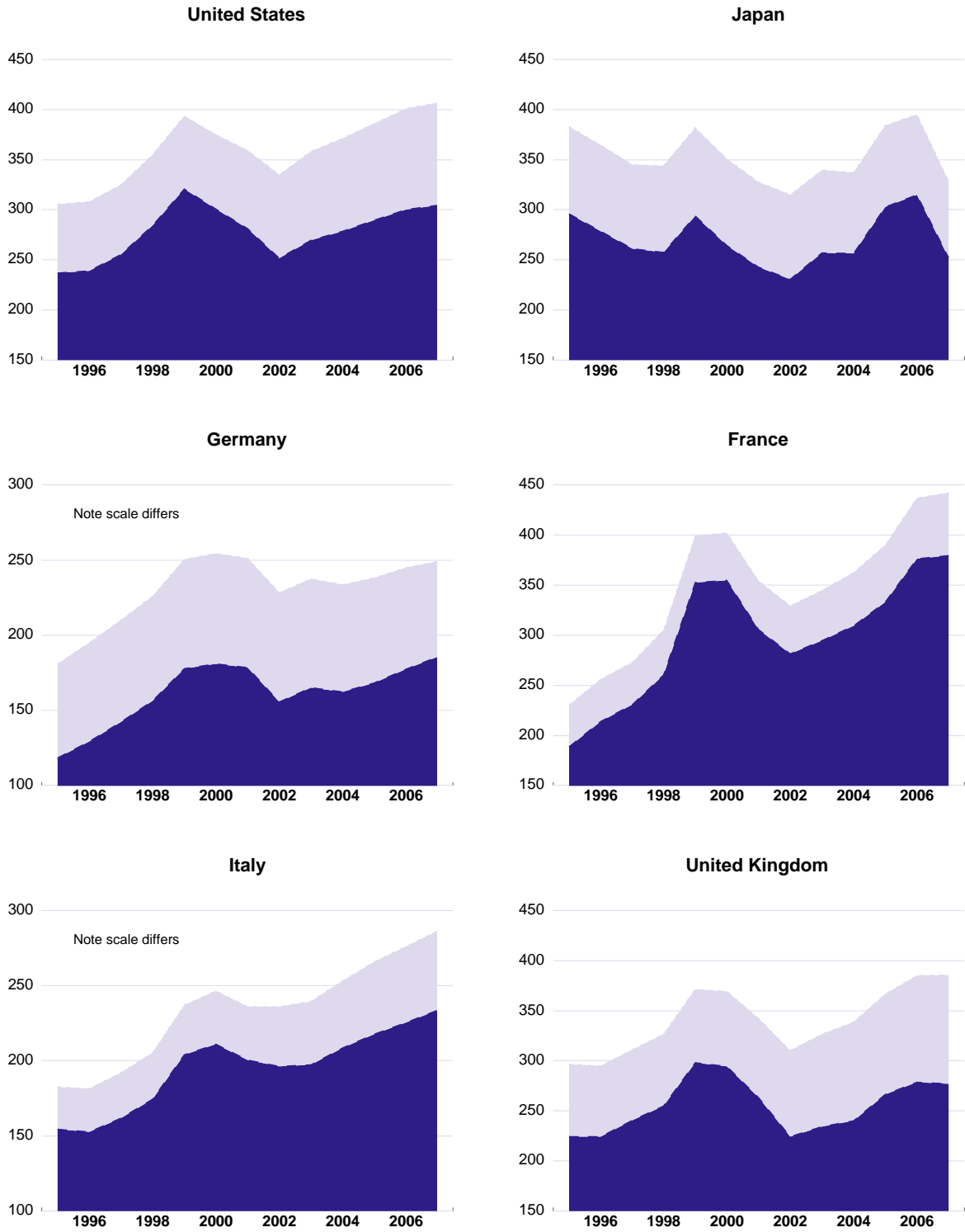
- Sound financial market regulation and supervision should be the first line of defence.
- More targeted interventions, such as changing maximum loan-to-value ratios, may be warranted when there is concern that an asset price misalignment is emerging.
- In the absence of sufficiently robust financial market oversight, monetary policy will need to be vigilant. When an asset price boom is associated with strong credit growth, monetary policy can be effective through altering the price of leverage. In light of the costs of the recent crisis, consideration should be given to using monetary tools if micro and macro-prudential policies are insufficiently robust, even if these tools are not best suited to counteracting asset price bubbles. The need to avoid destabilising the economy and to maintain inflation expectations well-anchored nonetheless constrains such “leaning against the wind”, which may be particularly circumscribed in small, open economies.

6. The financial crisis has highlighted that the regulatory and supervisory focus on individual institutions may not sufficiently take into account systemic risks. Adding oversight at the macro-prudential level as an overarching layer on top of micro-prudential supervision of financial markets would help detect the building-up of vulnerabilities. Better macro-prudential oversight would draw different sets of policy makers together and foster a better dialogue between monetary policy makers and regulators and supervisors with a shared macro-prudential focus.

Figure 3. Household and non-financial corporation debt

Per cent of GDP

■ Non-financial corporations ■ Households



Source: OECD Annual National Accounts.

A role for structural policies

7. Structural policies are not primarily set to strengthen the resilience of an economy, but they can directly and through their interaction with macroeconomic policies influence how shocks affect the economy. For example, during a downturn unemployment benefits rise and tax revenues diminish, implying automatic fiscal stabilisation. While the automatic stabilisers have an important place, particularly with respect to demand shocks, the fiscal policy instruments that underpin them are usually designed in the first instance to cater for equity or efficiency objectives, with automatic stabilisation arising as a side-benefit.

8. Other structural policies can influence the vulnerability of an economy to shocks. For example, reforms to housing and tax policies offer potential means to damp volatility.

- Tax incentives supporting homeownership, in particular mortgage interest rate deductibility, tend to raise the leverage of households, making them more vulnerable to shocks. Property taxes that are linked to current house price valuations, on the other hand, have some potential to stabilise the housing market.
- Tax policy that favours debt over equity financing provides incentives for increased leverage of firms making them and banks or other creditors more vulnerable to shocks.

9. In general, policies and institutions that reduce labour and product market frictions may sharpen the initial impact of a shock but also reduce its persistence, by allowing faster reallocation, which can help speed the return to trend growth after a temporary shock or the adjustment to a permanent shock.

Suggested further reading

The main paper summarising the project is:

Sutherland, D., P. Hoeller, B. Égert and O. Röhn (2010), “Counter-cyclical Economic Policy”, *OECD Economics Department Working Papers*, No. 760.

Supporting papers include:

Adam, K. (2010), “Optimal Monetary and Fiscal Stabilisation Policies”, *OECD Economics Department Working Papers*, No. 765.

Crespo Cuaresma, J. (2010), “Can Emerging Asset Price Bubbles be Detected?”, *OECD Economics Department Working Papers*, No. 772.

Davis, E. P. (2010), “Asset Prices and Real Economic Activity”, *OECD Economics Department Working Papers*, No. 764.

Égert, B. (2010), “Fiscal Policy Reaction to the Cycle in the OECD: Pro- or Counter-cyclical?”, *OECD Economics Department Working Papers*, No. 763.

Égert, B. (2010), “The Nature of Financial and Real Business Cycles”, *OECD Economics Department Working Papers*, No. 771.

Röhn, O. (2010), “New Evidence on the Private Saving Offset and Ricardian Equivalence”, *OECD Economics Department Working Papers*, No. 762.

Sutherland, D. (2010), “Monetary Policy Reaction Functions in the OECD”, *OECD Economics Department Working Papers*, No. 761.

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